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SETTING THE RECORD STRAIGHT

Inaccurate Assertions and Claims About the Administration's Proposal for "Life Cycle Funds" in Social Security Personal Accounts

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Recent claims have been made that if future asset returns match US historical returns then 32 percent of the workers who opt for Social Security personal retirement accounts and who choose a "life-cycle portfolio" will earn less than if they stay with the traditional Social Security system. If future asset returns match what has been described as "more realistic adjusted returns" then 71 percent of workers who opt for PRAs will earn less than if they stay with the traditional Social Security system.

These arguments are made in a March, 2005 paper by Yale economist Robert J. Shiller. The arguments are misleading and fail to explore fully important implications of its assumptions.

Background

President Bush's proposal for personal accounts is modeled on the personal account program available to Federal employees, the Thrift Savings Plan (TSP). Like the TSP, the Administration's proposal would allow workers to choose between a small number of simple, broadly indexed funds of bonds and stocks. The Administration has cited the "life cycle fund" soon to be made available by the TSP and has indicated that a "life cycle fund" would also be made available to participants in Social Security personal accounts. This fund would protect workers from market swings on the eve of retirement, while allowing them to receive the benefits of long-term investment in capital markets.

The March, 2005 paper by Robert Shiller purports to examine the effects of such a "life cycle fund" investment option upon total Social Security retirement benefits.

Myths and Facts

1. The "baseline" life cycle fund analyzed in the paper shows average returns of only 3.4 percent after inflation. This is the fund that generates the 32 percent figure cited above as the share of workers who would do worse with PRAs than with the traditional Social Security system.

- The fund analyzed in the paper bears no clear relationship to an Administration proposal. It is a hypothetical fund.

- The fund assumes a gradually increasing share of bonds, eventually reaching 85 percent of the total, half of which is in government bonds and half in money market funds.

- The allocation to low-return money market funds is much greater than the allocations to money market funds in the private-sector life cycle funds cited in the paper. For example, the Vanguard Target Retirement Fund (for current retirees) has a money market allocation of 5 percent; the T. Rowe Price Retirement Income Fund has a "conservative fixed income" allocation of 30 percent. The paper assumes a money market allocation of 42.5 percent at retirement. The heavy allocation to low-yield instruments contributes enormously to the findings of low returns from the life cycle fund.

- The paper provides a simulation of what is called an "aggressive life cycle portfolio" with asset allocations that more closely resemble those of the private-sector life cycle funds cited in the paper. That simulation suggests 92 percent of those who opt for PRAs would receive more in benefits than with the traditional Social Security system.

2. Using international asset returns, the paper projects the "baseline" portfolio will earn only 2.6 percent after inflation in which case 71 percent of workers would do worse with PRAs than with the traditional Social Security system.

- In this scenario, future US stock returns are assumed to be the lower historical stock returns of other nations, including ones that have lost armed conflicts resulting in their being occupied by foreign military forces.

- The source for a lower equity return assumption (4.8 percent after inflation) actually reports an overall international growth rate of 5.4 percent after inflation. The paper adjusts this figure downward by using an international median that largely removes US data from the calculation.

- By using an international median, the paper avoids using the returns investors earned if they invested in each country in proportion to the size of their markets. For example, Belgium counts just as much as the United States.

3. Regarding the Bush Administration's proposal for personal accounts, the paper says ". . . the worker has not really diverted his or her Social Security contributions into a personal account, but has merely borrowed from the government to invest in a personal account, and must eventually pay the loan back."

- Under the President's proposal for personal accounts, an individual could voluntarily choose to invest some of his payroll taxes in a personal account instead of paying all of his payroll taxes to the traditional system. Paying less into the traditional system than those without accounts, he will withdraw less from it, although projections are that his total benefits will increase when the retirement income from his personal account is included.

- There is no "loan." The worker simply chooses to shift some of his investment from one vehicle to another, with the consequence that he will receive less in future benefits from the first system, and more from the second. To describe the shift of funds, and the resulting shift in eventual benefit payments, from one retirement vehicle to another, as a "loan" is misleading and false.

4. The paper states that the President's proposal is designed to encourage workers to take "margin loans" to invest in stocks and bonds.

- We have already seen that the description of the President's proposal as a "loan" is incorrect. It is also incorrect to equate the President's proposal with a push of investors into stocks or into any other particular investment.

- Under the President's proposal, individuals could make the investment choices that they wish, whether they are in government bonds, corporate bonds, or stocks. In addition, the purpose of personal accounts is to increase saving, to prevent the federal government from spending Social Security money, to establish personal ownership within the Social Security system, and to allow for the inheritability of assets -- not to dictate individuals' investment decisions.

5. A significant component of the finding of low returns from the paper's life cycle fund is the assumption of lower returns from bonds than assumed by the Social Security actuaries.

- By assuming that bonds will earn less than the SSA actuaries' assumptions, the paper produces the following results, some of which are noted in the paper, some of which are not:

  - *Depressed Portfolio Returns:* The assumption of lower bond returns results in lower portfolio returns than found by the SSA actuaries. Notably, the SSA actuary and Trustees already assumes lower bond returns than does the Congressional Budget Office, so the paper is considerably on the low side of the non-partisan government scoring agencies.
  - *Personal accounts help the system:* The assumption that government bonds will earn less than 3 percent, after inflation, carries an implication that is not explored in the paper: namely that the government could borrow to fund the personal accounts and still take on less additional costs, including debt service, than the savings generated by the accounts through a 3 percent offset rate. In other words, the paper implicitly argues that personal accounts will help the system's finances, and thereby make the traditional system healthier for those without accounts.
  - *System going bankrupt sooner:* A lower rate of interest on government bond funds would cause the Trust Fund to be depleted earlier than is now projected by SSA. For example, CBO's later projected insolvency date of 2052 (relative to SSA's 2041) is partially because CBO is projecting a higher rate of interest on bonds held by the Trust Fund. If the paper is correct and Treasury bonds earn less than now projected by the Social Security actuaries, then the current system will become insolvent sooner than now projected.
  - *A bigger problem than now projected:* Currently, SSA projects that Social Security faces unfunded liabilities of $4.0 trillion over the next 75 years, and $11.1 trillion over all time. These figures are discounted with the assumption of 3 percent interest above inflation. If the paper is correct and the government's borrowing rate will be less than 3 percent in the future, then Social Security's unfunded liabilities will be *significantly larger* than now projected.

- In sum, the argument for lower bond returns can only be correct if it is simultaneously held that Social Security's problems are much more severe than currently being projected by the Trustees and that President Bush's personal accounts would have a beneficial impact on system finances.

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